MCI Communications Corporation

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1801 Pennsylvania Avenue, NW
Washington, DC 20006

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March 16, 1999

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
TW-A325
445 12th Street, S.W.
Washington, D.C. 20554

Re: **CC Docket No. 98-166; Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers, Notice of Proposed Rulemaking**

Dear Ms. Salas:

Enclosed herewith for filing are the original and four (4) copies of MCI WorldCom, Inc.'s Reply Comments in the above-captioned proceeding.

Please acknowledge receipt by affixing an appropriate notation on the copy of the Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Chris Frentrup

Chris Frentrup
Senior Economist
1801 Pennsylvania Ave, NW
Washington, DC 20006
(202) 887-2731

MCI WorldCom, Inc.

Enclosure

MCI Communications Corporation

MCI

1801 Pennsylvania Avenue, NW
Washington, DC 20006

March 16, 1999

Warren Firschein
Accounting Safeguards Division
Federal Communications Commission
2000 L Street, N.W.
Room 257
Washington, D.C. 20554

Re: **CC Docket No. 98-166; Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers, Notice of Proposed Rulemaking**

Dear Mr. Firschein:

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cc: ITS

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Prescribing the Authorized Unitary	)	**CC Docket No. 98-166**
Rate of Return for Interstate Services	)	
of Local Exchange Carriers	)	

REPLY COMMENTS OF

MCI WORLDCOM, INC.

MARCH 16, 1999

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SUMMARY

MCI WorldCom urges the Commission to represcribe the authorized rate of return for non-price cap regulated carriers to reflect the current cost of capital. This should result in a reduction to about 9.27 percent, as evidenced in the study of cost of capital filed by the General Services Administration. The methodology used to determine the rate of return should be that proposed by the Commission in its Notice, employing a discounted cash flow analysis to determine the cost of equity, and balance sheet values to determine the relative weights of debt and equity. Such a methodology accurately captures incumbent local exchange carrier (ILEC) cost of capital, and requires no explicit adjustment to reflect ILEC business risk. Similarly, it requires no upward adjustment to give the ILECs an incentive to invest in infrastructure, as such an adjustment will serve only to distort market incentives for such investment. Finally, the lower formula adjustment mechanism in the Commission's price cap plan should be eliminated, or at a minimum reduced in line with the reduction in the cost of capital, so that price cap regulated ILECs will not be guaranteed a rate of return greater than their current cost of capital. This change is also needed to restore the balance of risk and rewards to the Commission's price cap plan.

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Prescribing the Authorized Unitary	)	**CC Docket No. 98-166**
Rate of Return for Interstate	)	
Services of Local Exchange Carriers	)	

REPLY COMMENTS OF MCI WORLDCOM, INC.

I. INTRODUCTION

On October 5, 1998, this Commission released a Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking ("Notice")[1] proposing to conduct a proceeding to represcribe the rate of return for the incumbent local exchange carriers (ILECs) that are subject to rate of return regulation for interstate services. This represcription effectively would serve to update the previous rate of return represcription completed by this Commission in 1990 pursuant to CC Docket No. 89-624 which established a rate of return of 11.25 percent, including an implied return on common equity of 13.2 percent. The present Notice follows a sharp decline in long-term interest rates, as measured by the yields on ten-year Treasury notes.

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[1] Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 98-166, Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking, FCC 98-222, (released October 5, 1998) ("Notice").

The Notice tentatively concludes that the Commission should proceed with a represcription and seeks comments on a number of methodological and computational issues concerning cost of equity.[2] The Notice proposes to use a methodology similar in many respects to the one adopted in the prior represcription in 1990. In addition, the Notice at ¶54 asks whether the represcribed rate of return should be incorporated into the "low end formula adjustment" for the price cap ILECs.

On January 19, 1999, comments were submitted by several parties including the General Services Administration (GSA), U S WEST, Inc., the Local Exchange Carrier Associations,[3] Bell Atlantic, and GTE Corporation. MCI WorldCom, Inc. ("MCI WorldCom") is pleased to submit these Reply Comments to respond to the arguments of these parties. MCI WorldCom supports this Commission's stated intention to represcribe the authorized rate of return. The currently authorized return is nearly ten years old, and it is clear to any observer that capital costs have declined sharply since that time, notwithstanding some increases in business risk facing the industry which may have occurred since the passage of the Telecommunications Act of 1996. Moreover, MCI WorldCom also supports the tentative finding in the Notice that the application of the "classic" Discounted Cash Flow (DCF) model to a proxy group consisting of the Regional Bell Operating Companies (RBOCs) remains a reasonable methodology that will yield an accurate cost of capital finding.

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2 Notice, ¶4.

3 The joint submittal is sponsored by the United States Telephone Association, the National Telephone Cooperative Association, the National Rural Telecom Association, the Organization for the Promotion and Advancement of Small Telecommunications, the Independent Telephone and Telecommunications Alliance and the National Exchange Carrier Association.

II. OVERVIEW OF THE ISSUES

A. Major Arguments Raised in Initial Comments

With the exception of GSA, all of the parties filing comments urge that the Commission not proceed with a rate of return represcription at this time.[4] The represcription opponents (all of whom represent ILECs) advance two categories of argument in support of their position.

First, they assert that the ILEC overall cost of capital probably has not declined since 1990 and may have increased, even though they would not dispute that capital costs in general have declined. According to these arguments, the general capital cost decline has been fully offset by a combination of increased business risk (from the 1996 Telecom Act and its implementation) and the need of ILECs to finance with greater equity.

Second, they argue that even if the Commission concludes that some decrease in the ILEC cost of capital has occurred, there are an array of policy considerations which favor retaining the current 11.25 percent return. These considerations include fostering telecommunications infrastructure investments, achieving economic efficiency and ensuring that small, rural ILECs have access to capital on reasonable terms.

The ILEC-sponsored comments spend virtually no time addressing the cost of equity methodology or computational questions posed in the Notice. The ILECs' most prominent recommendation is that the Commission should adopt a "market-based" capital structure (about 80 percent common equity) in place of the balance sheet or book value capital structure (about 57

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[4] GSA favors represcription of rate of return using a methodology similar to that previously used by this Commission in CC Docket No. 89-624. GSA's analysis finds a reasonable range of 9.0 to 10.0 percent with a recommended point estimate of 9.5 percent. See GSA at 25.

percent equity) previously used by the Commission. Only one ILEC party, U S WEST, addressed the cost of equity methodology issues in detail. U S WEST supports the use of the "classic" DCF method, subject to certain modifications, in conjunction with the Capital Asset Pricing Model (CAPM).

Finally, the ILEC parties argue that no change should be made to the lower formula adjustment mechanism (LFAM). The basis for this position is the same set of arguments regarding increased business risk and telecommunications policy considerations that the ILEC parties use to oppose conducting a represcription proceeding at this time.

B. Summary of MCI WorldCom Response

The threshold question is whether the apparent changes in capital market conditions are sufficient to warrant a represcription. GTE argues that a decline in Treasury note yields by itself is not sufficient.

> In considering whether represcription should occur, GTE believes that there must be a clear indication that -- viewed in their entirety -- the changes in the capital markets and the altered risks of the LECs since the last represcription are significant enough to warrant a new finding. (GTE, page 3)

While conceding that interest rates have declined, GTE asserts that for ILECs this has been more than offset by greater business risk and the need for a debt/equity ratio that is more heavily weighted toward equity.

The ILEC parties, however, offer only anecdotal evidence concerning increased business risk. The issue here is not whether business risk has increased, but whether this increase is so large as to offset completely the salutary effects of improved conditions in capital markets. There has been no showing that an increase in risk of this magnitude has occurred. Indeed, the ILEC

parties do not even attempt to explain why the capital market information which is the basis of the Commission's proposed methodology would fail to incorporate this allegedly increased risk. The capital structure issue, which plays so prominent a role in the ILEC comments, is merely an argument for adopting a new methodology. It is unrelated to the threshold criterion articulated by GTE. By comparison, GSA provides analytic and quantitative evidence that the ILEC cost of capital has declined significantly.

The ILEC parties also advance various policy arguments for this Commission to refrain from lowering the rate of return. U S WEST argues in opposition to represcription that "the Commission should use market forces to allocate capital." (U S WEST, page 8) Arguments are also advanced that reducing the rate of return at this time (presumably by failing to use a market-based cost of capital measure) would discourage telecommunications infrastructure development and misallocate resources.[5]

These arguments are incorrect and overlook some fundamental facts. There is no dispute that the rates charged for interstate access service are well above economic costs. Hence, a reluctance to recognize a decline in the cost of capital exacerbates a pricing methodology for interstate access which is already economically inefficient. This inefficiently high price for access discourages infrastructure investment by those firms that purchase interstate access services. Market forces alone cannot be relied upon to allocate resources efficiently and protect consumers if that market is not considered to be workably competitive.

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[5] See, e.g., Vander Weide Affidavit, para. 18-20 and 37, attached to the comments of US WEST, GTE, and Bell Atlantic.

The assertions of the ILEC parties that any rate of return adopted by the Commission be market-based is a distraction. As explained later in these Reply Comments, the methodology proposed in the Notice and supported by MCI WorldCom will produce a reasonable approximation of the ILEC incremental cost of capital. In using the term "market-based cost of capital," the ILEC parties are seeking Commission adoption of a capital structure consisting of 80 percent equity and 20 percent debt in order to avoid recognizing that the cost of capital -- even to phone companies -- has declined sharply since 1990. In addition, they are urging adoption of a capital structure that the Commission has already rejected, when it set the current 11.25 percent rate of return.[6]

MCI WorldCom concurs with GSA that the proper way to calculate cost of equity is to apply the "classic" DCF formula to the RBOC proxy group. The modifications advocated by U S WEST's expert, Mr. Cummings, while minor, should not be adopted. We also do not agree with Mr. Cummings that the RBOC cost of equity estimate is improved by averaging the DCF with the results of a CAPM study. While the CAPM conceptually is a valid model, its use requires too many controversial and speculative assumptions. In particular, the CAPM model requires a determination of the investor expected rate of return on the overall stock market, an even more difficult task than directly estimating the cost of equity for telephone companies. This and other CAPM application problems are described, infra, in Section V.E. Finally, MCI WorldCom believes that the debt and preferred stock cost rates and capital structure presented in Appendix B in the Notice are satisfactory, subject to updating for 1998 ARMIS data. These data are broadly

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[6] See In the Matter of Represcribing the Authorized Rate of Return for Interstate Service of Local Exchange Carriers, Order, CC Docket No. 89-624, 5 FCC Rcd 7507, 7520-1 (ROR Prescription Order) at paras 115-117.

representative of how the ILEC industry is actually financed and are consistent with credit rating agency requirements for single or double A bond ratings.

III. CAPITAL COST AND FINANCIAL PERFORMANCE TRENDS

Before exploring in more detail the arguments from the initial comments, it is worthwhile comparing current or recent capital costs with those at the time of the previous rate of return represcription in 1990. A close examination will reveal that the decline is not merely confined to Treasury securities, as suggested, but is broad based. The bonds of the major ILECs are typically single or double A rated. According to Moody's Bond Record, double A utility yields averaged about 9.6 percent in 1990 compared to 6.8 percent by year-end 1998, a reduction of nearly 3 full percentage points. Long-term Treasury bond yields fell by even more during this period, from 8.6 percent in 1990 to about 5 percent by year-end 1998. Although ILEC witness Dr. Avera's "flight to quality" observation regarding capital markets in 1998 is correct, it is also clear that the decline in interest rates has been broad based and applies to ILEC securities as well.

The decline in the cost of debt has been accompanied by a concomitant decline in the cost of equity. The S&P 500 index advanced from a value of 335 in 1990 to over 1,200 by year-end 1998. This rapid advance is undoubtedly partly attributable to the growth in corporate earnings, but much of the advance is also powerful evidence of a decline in capital costs. The S&P 500 dividend yield fell from 3.6 percent in 1990 to 1.4 percent by year-end 1998. Similarly, the S&P 500 earnings/price ratio declined from 6.5 percent in 1990 to about 3.5 percent by year-end 1998.[7] It seems implausible that the cost of equity since 1990 has declined sharply for the S&P 500, but not for telephone companies.

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[7] Source: Economic Report of the President, February 1999, page 436.

There are clear and compelling reasons why capital costs have fallen as much as they have. First, there has been a dramatic change in federal fiscal policy. In 1990, huge federal deficits were absorbing a large portion of incremental investment funds in the U.S. Stocks and bonds (including telephone stocks) were forced to compete with federal borrowing, driving up the cost of capital. The federal government is now running a surplus, thereby contributing to national savings. An even more important development is the virtual disappearance of inflation. As measured by the Consumer Price Index, inflation at the time of CC Docket 89-624 was about 5 to 6 percent, compared to 1.6 percent in 1998.

A review of the financial performance of the phone companies in recent years (the RBOCs and GTE) brings into question the ILEC assertions of heightened risk and investor anxiety. The following table presents the telephone company earned return on common equity over the last five years, a period which straddles the 1996 Telecommunications Act.

Return on Equity, 1994-1998

Company	1994	1995	1996	1997	1998
Ameritech	27.9%	26.9%	27.5%	28.2%	26.5%
Bell Atlantic	25.4	25.4	23.4	29.0	24.0
BellSouth	14.6	18.8	19.0	18.4	19.5
GTE	21.8	36.8	38.0	34.8	31.0
SBC	19.7	30.2	30.7	34.0	32.0
U S WEST	34.6	31.8	29.7	25.0	NMF
Average	24.0%	28.3%	28.1%	28.2%	26.6%

Source: Value Line Investment Survey, January 8, 1999.

This table reveals a remarkably stable performance, not an industry in turmoil.

An even more compelling picture emerges by examining market returns instead of accounting returns over the past five years. The following table is a compilation of market returns to investors on the common stock of these same six telephone companies over the past year, three years and five years, with the latter two measures encompassing the passage of the 1996 Telecommunications Act and this Commission's implementation of the Act's provisions.

Total Annualized Market Returns

Company	1 Year	3 Years	5 Years
Ameritech	56.7%	34.0%	30.5%
Bell Atlantic	41.1	27.4	22.6
BellSouth	51.1	31.6	28.4
GTE	27.9	18.1	19.7
SBC Corp.	42.6	27.8	24.8
U S WEST	33.6	27.6	NA
Average	42.2%	27.8%	25.2%

Source: Standard & Poor's Stock Guide, February 1999.

These market return results could not possibly have occurred over the past year, three years and five years if the RBOC cost of capital was increasing due to heightened business risk, as implied by the ILEC commenters.

IV. ARGUMENTS TO DELAY REPRESCRIPTION ARE NOT PERSUASIVE

The Notice seeks comments on a number of issues concerning cost of capital application techniques and data sources, which could serve as a basis for modifying the methodology employed by the commission in CC Docket No. 89-624, in light of changes that have occurred

since 1990. Instead of addressing these issues, the ILEC parties present arguments for not conducting a cost of capital investigation at all. As discussed below, these arguments are flawed and should not serve as a basis for disregarding the clear reduction in capital costs.

A. Increased Business Risk Has Not Offset Market Capital Cost Declines

The ILEC parties expend considerable energy discussing and documenting with anecdotal evidence the increase in business risk associated with local exchange service. However, while competitors are beginning to emerge, local exchange service remains primarily monopolistic. In the meantime, ILECs are benefitting from the steady growth in the demand for the telecommunications services they provide, with minutes and lines increasing year over year despite the presence of emerging competitors.

While business risk may be increasing for the ILECs, ultimately this is an elusive and fruitless line of argument. No systematic quantification of increased risk has been presented, nor is there any evidence from the comments that the increase in risk is so great as to fully offset the declining market cost of capital.

The point which is missed in the ILEC comments is that a properly performed cost of equity study (i.e., one using the DCF model) resolves this issue, because such a study automatically captures all ILEC business risk.[8] Hence, the arguments concerning increased ILEC business risk are best and properly resolved within a rate of return represcription proceeding using a properly designed DCF cost of equity study. Such a study has been placed on the record by GSA, and found the current cost of capital to be 9.27 percent.

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[8] As has been previously recognized, the use of RBOC stock prices in a DCF study may overstate somewhat ILEC risk for interstate access service because it incorporates the risks of overseas and competitive businesses.

B. Reducing the Authorized Rate of Return will Not Impair Infrastructure Investment in Local Exchange Networks and Lead to a Less Efficient Telecommunications Industry

The ILECs focus their argument on the effect of a lower rate of return on themselves, but ignore the effect of an excessive return and excessive interstate access rates on those communications firms that purchase interstate access service. The fact is that interstate access service remains, by and large, a monopoly service[9] and is being priced far above economic cost. The decline in the cost of capital provides an opportunity to reduce the price of interstate access service (provided by the rate of return ILECs), toward economic cost, while allowing a fair return on investment. The point is that lower cost access service benefits the ultimate consumer, encourages investment by telecommunications companies who must purchase network access and is consistent with economic efficiency and resource allocation. The record clearly shows that the ILECs' cost of capital has fallen. While maintaining an excessive rate of return might give the ILECs an incentive to invest more in access services, it will do so at the cost of economic efficiency in both the access and interexchange markets. It would also be inconsistent with the Commission's own rules, which require that the cost of capital reflects current financial conditions.

Thus, ignoring a declining cost of capital when setting rates for interstate access does not serve the interests of consumers, nor is it consistent with economic efficiency.

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[9] As stated by the Notice at ¶20:

> The RBOCs and rate-of-return ILECs both provide interstate services, their primary business is still the provision of telephone service and neither is subject to any meaningful competition for regulated telecommunications services in their service area.

C. No Evidence Has Been Presented That a Reduction in Rate of Return will Impair Access to Capital for the Small ILECs

This issue was discussed in the testimony of Dr. William Avera on behalf of Local Exchange Carriers Association (pp. 34-40). His testimony discusses various sources of funding for small companies, including the Rural Utilities Service (RUS) for rural cooperative telephone companies. Dr. Avera indicates that the possible sources of financing for new investment are limited.

What is missing from this discussion is any evidence that the rate-of-return ILECs either do not have access to financial capital at the present time, or that the access would be denied if their rate of return was adjusted to reflect current conditions in capital markets. For example, Dr. Avera does not discuss the most important financing source of all for telephone companies -- internally generated cash. Moreover, Dr. Avera's testimony seems to be inconsistent with the ILEC theme that 80 percent of capital investment should be financed with equity.

D. Balance Sheet versus Market-Based Capital Structure

The comments of the ILEC parties heavily emphasize the need to switch from using the balance sheet-derived capital structure previously used by this Commission to a "market-based" capital structure. The difference between the two is that the market-based approach simply inflates the balance sheet equity component by the (publicly-traded) parent company's market-to-book ratio. The ILEC Comments indicate that this approach produces an 80 percent equity/20 percent debt capital structure, compared with the 57 percent equity/43 percent debt shown in Appendix B of the Notice. Since equity is far more costly than debt, the capital structure change

is sufficient to offset much if not all of the decline in capital cost rates. Thus, the ILEC parties argue on this basis for abandonment of the represcription proceeding.

U S WEST witness, Mr. Peter C. Cummings, asserts that the use of balance sheet (or book value) capital structure is purely a creature of monopoly utility regulation and has no place in the emerging competitive world of telecommunications (pp. 8-9). He and the other ILEC witnesses argue that it is now time for the FCC to abandon this outdated concept.

Capital structure simply refers to the mix of debt and equity financing which a firm uses to finance its investment in plant and equipment. This may refer either to the financing of its existing capital stock, or the concept can be "incremental" and refer to the mix of debt and equity that the company would use to finance its capital expansion program.

Mr. Cummings' argument concerning capital structure is incorrect from a number of perspectives. First, the ILECs argue that four of every five dollars financing their capital stock comes from equity (or, taking an incremental approach, that the capital expansion program will be financed almost exclusively from equity). The following table presents the total debt balance and net plant for each RBOC (and GTE) at year-end 1998.

	Total Debt versus Net Plant (million $)		
Company	Debt Balance	Net Plant	Debt/Net Plant Ratio
Ameritech	$8,242	$14,105	58.4%
Bell Atlantic	20,125	36,500	55.1
BellSouth	11,903	24,230	49.1
GTE	18,300	25,680	71.3
SBC Corp.	12,847	28,500	45.1
U S WEST	9,833	15,165	64.8

Source: Value Line Investment Survey, January 8, 1999.

This table demonstrates that historically the RBOCs have made extensive use of debt to finance their capital stock. This heavy usage of debt is neither happenstance nor an anomaly but represents the deliberate choice and revealed preference of RBOC management. Moreover, it must be presumed that this represents cost minimizing behavior by the RBOCs. On a going forward basis, it is possible that this historic reliance on debt could change and the companies could make greater use of common equity. But why would they? Equity is far more expensive than debt, and it is income tax disadvantaged since equity return dollars (unlike debt interest) are not a deductible expense. None of the ILEC comments can substantiate the notion that only one dollar out of five to finance telecommunications capital expansion will come from debt.

Nor is the use of balance sheet values to measure capital structure merely an artifact of regulation, as the ILECs claim. Investor service organizations such as Value Line provide capital structure ratios in their research reports based on balance sheet data. Standard & Poor's (S&P) makes use of financial ratio benchmarks to rate the bonds of both utilities and industrial companies. For example, S&P's published benchmark for telephone operating companies specifies that a debt ratio of 42 percent or less corresponds to AA, 40 to 52 percent is single A

and 50 to 62 percent is BBB.[10] In applying these benchmarks, the debt ratio (debt/total capital) is calculated from balance sheet values, not market values. The 43 percent average telephone company debt ratio shown on Appendix B of the Notice is consistent with a rating of low double A/high single A. Thus, given the S&P debt ratio benchmark, there is no reason for telephone operating companies to adopt an 80/20 capital structure either to finance total capital or on an incremental basis. Such a capital structure would be unnecessarily expensive.

E. The Issue of a Market-Based versus Embedded Cost of Capital

The ILEC parties' comments emphasize that any cost of capital employed by this Commission should be based upon market data rather than embedded cost. In this case, using the capital structure and cost rates in Appendix B to the Notice and a cost of equity derived from a DCF study will approximate a market-based or incremental cost of capital.

As mentioned above, the capital structure ratios in Appendix B of the Notice provide a reasonable mix of debt and equity for an ILEC on a going forward basis and conform to S&P benchmarks for a single or double A telephone company. A DCF-derived cost of equity is, by definition, a market-based and incremental cost rate. The debt and preferred stock cost rates are embedded costs rather than market costs. However, the 7.35 percent embedded cost rate appears to be slightly higher than the cost of new debt, and thus represents (from the ILECs' standpoint) a conservatively high estimate of the current cost of debt. The embedded cost rate of preferred stock differs significantly from incremental cost, but since it accounts for only a minuscule 0.14 percent of total capital, the effect on overall rate of return is negligible.

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[10] Standard & Poor's, Corporate Ratings Criteria, 1996, page 86.

F. The Lower Formula Adjustment Mechanism

The Notice proposes to update the LFAM used by the price cap ILECs for the change in the represcribed rate of return (¶54). The LFAM provides down-side earnings protection for those price cap ILECs unable to achieve the productivity gains or cost controls expected under the price cap formula. The ILEC parties object to this proposal, mainly because they do not believe that there is a basis for represcribing rate of return at this time. That is, they argue that the cost of capital for the ILECs has not declined, and thus the LFAM rate of return trigger should not be changed.

The ILECs' comments do not adequately address the real issue; i.e., if the cost of capital has declined, should the LFAM trigger value (now 10.25 percent) be reduced accordingly? As MCI WorldCom stated in its comments, the Commission adopted a lower formula adjustment mark of 10.25 percent in its original price cap decision for several reasons. First, it set the mark below the unitary rate of return of 11.25 percent because it believed that an incentive regulation plan needed to present not only the possibility of gain if greater efficiencies were achieved, but also the risk of reduced earnings if the carrier failed to become more efficient.[11] To ensure that the price cap ILECs faced this risk, the Commission decided that the lower formula adjustment mark had to be set below the unitary rate of return, though "not so low as to cause a confiscatory result in the short term."[12] The Commission also stated that it considered it desirable that the lower formula adjustment mark be symmetrical with the top of the no-sharing zone, which was set

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[11] See In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd 6786, 6806 (LEC Price Cap Order) at para 164.

[12] Ibid.

at that time at one percent above the unitary rate of return.[13] For all these reasons, the Commission set the initial lower formula adjustment mark at 10.25 percent. Although this level was below the range the Commission identified at that time for the interstate cost of capital,[14] it was both within the range of costs of capital for other public utilities and above the marginal cost of long term telephone debt.[15] Since a return at that level would still allow companies to continue to attract capital and maintain service, the Commission argued, it would not be confiscatory. The Commission therefore adopted the 10.25 percent lower formula adjustment to "provide the proper balance of incentives and safeguards" to the price cap plan.[16]

It would be illogical not to adjust the LFAM for a lower cost of capital. The balancing of interests under the price cap formula provides the ILECs an opportunity for additional earnings if productivity targets are exceeded, but the Commission also originally intended that the price cap ILECs would be exposed to the risk of earnings below the equity cost rate if the productivity target were not met. It would be inappropriate to structure the formula with only upside potential and no downside risk.

Consider, for example, the case where the ILEC cost of capital has fallen to 9.5 percent -- as recommended by GSA -- but the LFAM trigger remains unchanged at 10.25 percent. In that

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13 Ibid. Since then, the Commission has eliminated any sharing requirement for the price cap ILECs, effectively allowing them to earn at any level.

14 In its ROR Prescription Order, the Commission found that a reasonable range of RORs for the ILECs was 10.85 to 11.4 percent. See ROR Prescription Order at para 214.

15 LEC Price Cap Order at para 165.

16 Ibid.

case, the price cap formula protection measure would begin at 75 basis points above the true cost of capital. If the price cap formula is to achieve its intended purpose and provide a balance of risks and rewards, the LFAM trigger value must at least be adjusted in accordance with changes in the cost of capital.[17] Otherwise, the price cap ILECs receive unlimited upside earnings potential, while being guaranteed to earn in excess of their true cost of capital.

V. COST OF EQUITY METHODOLOGY

The Notice identified a number of issues for comment concerning the proper method for calculating the cost of common equity. The details of cost of equity quantification were discussed by only two parties, GSA and U S WEST, the latter through the affidavit of Mr. Cummings. Both parties appear to support the proposal in the Notice to employ the classic DCF model, although Mr. Cummings believes the DCF study should be supplemented with CAPM study evidence. GSA argues that the RBOC group should be employed as the risk proxy for interstate access service, whereas Mr. Cummings did not endorse a specific DCF proxy group. MCI WorldCom supports the position of GSA in selecting the RBOC group.[18]

Mr. Cummings recommended several minor changes to the "classic" DCF model discussed in the Notice:

- inclusion of a flotation expense adjustment;

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[17] Indeed, as MCI WorldCom argued in its comments, to provide a balance of risks and rewards, the LFAM trigger rate of return must be either completely eliminated, or at a minimum revised each year for the ILECs' cumulative gains above the authorized rate of return. See MCI Comments at 5-7.

[18] It may also be appropriate to add GTE to that group, though that change is unlikely to have a substantial effect.

- utilization of the "quarterly compounding version" in place of the annual version; and
- use of a ten-day period to measure stock prices, rather than a monthly average.

While relatively minor, we disagree with each of these modifications.

A. Flotation Expense

At pp. 22-25 of his Affidavit, Mr. Cummings argues that the DCF cost of equity must be adjusted to provide recovery of stock issuance flotation expenses. He illustrates this need for recovery with a hypothetical example. The problem, however, is that Mr. Cummings provides no actual evidence that the RBOCs have actually incurred such expenses, whether such expenses (if ever incurred) remain unrecovered, or whether the RBOCs are expected to incur such expenses prospectively. With respect to the latter, there is no reason to believe the RBOCs will conduct a public issuance of common stock to finance network expansion and new plant related to interstate access service.

It is also important to recognize that even if and when an RBOC has a need to raise external equity, it can do so without incurring flotation expense (other than minor administrative expenses) through its dividend reinvestment and optional stock purchase programs. It is possible that a large portion of the equity on the books of the RBOCs may have been raised in this manner.

B. Quarterly Compounding

Mr. Cummings argues that a proper application of the DCF model would account for the quarterly timing of dividends. For example, an investor receiving a $10 return during the year on a $100 investment made on day one would not be indifferent to the timing of the $10.00. In this case, if the $10 was received on day 365, the effective annualized return would be 10 percent.

However, if the $10 was received as quarterly payments of $2.50, then the effective annualized return would be slightly greater because the investor could reinvest the payments received at the end of quarters (1), (2) and (3) and earn a small amount of additional return. The case for a quarterly compounding adjustment is no more complicated than that.

This modification to the "classic" DCF model has received very little regulatory acceptance due to some of the arguments against it discussed in the Notice. This adjustment was studied in considerable detail during the late 1980s by the Federal Energy Regulatory Commission (FERC) as part of that agency's generic or "benchmark" rate of return for electric utilities, and it was ultimately rejected.[19]

There is good reason for rejecting this adjustment in the context of public utility ratemaking. Returning to the above example, the four quarterly payments of $2.50 indeed will provide an effective annualized return slightly more than 10.0 percent. But what happens if that increment is ignored and the utility is awarded only a 10 percent return based on the annual DCF model? Standard ratemaking then provides the utility with a 10 percent return (on the equity portion of rate base), but that return is not provided to the utility by its customers as a lump sum on day 365 of the year. Rather, the utility receives its rate of return on equity dollars more or less continuously throughout the year. This means that due to the timing of the return on equity cash flow, the utility is provided an opportunity to obtain additional earnings through reinvestment.

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[19] The FERC initially adopted a quarterly compounding adjustment in 1985 in Order No. 442. However, for ratemaking purposes, the FERC employed an offsetting adjustment to remove quarterly compounding, "the ratemaking rate of return." Realizing that including and then removing quarterly compounding accomplished little, in subsequent generic proceedings, the FERC abandoned the use of the quarterly compounding DCF model.

Alternatively, the utility pays out the return on equity dollars to its shareholders on a quarterly basis and they are able to reinvest the dividend payments and earn additional return. This means the "problem" identified by Mr. Cummings is automatically corrected by the ratemaking process itself and the quarterly compounding adjustment to the DCF return is not needed.

C. Other Adjustments to the Classic DCF Model

In CC Docket No. 89-624, the FCC incorporated a series of adjustments to the DCF results for the "cellular effect," the variation of returns across RBOCs, the lower risk of interstate access service and infrastructure development. In paragraph 41 of the Notice, the Commission seeks comments on whether such adjustments continue to be needed. Although the importance of infrastructure development is discussed in a general way by most of the parties, it appears that only GSA has addressed the need to modify the DCF calculations for these factors. GSA urges rejection of these various adjustments on the grounds that they are already captured by a properly performed DCF analysis.

We concur with GSA on this issue. The cellular argument received only limited weight in this Commission's 1990 proceeding, and there is no evidence supporting its use today. It is no longer credible to argue that financial analysts today ignore the earnings growth from RBOC cellular operations in their published growth rate forecasts, and none of the commenting parties argue that this is the case.

Similarly, no upward adjustment to the rate of return is needed for the variations in estimated return across the RBOCs constituting the proxy group. While such variations could indicate small cost of equity differences from company to company, it is more likely to be simply an indication that there is some random element (i.e., "noise") in stock prices and published

growth rates. Using a proxy group is useful because it helps to cancel out random data fluctuations, and its use is a common practice among financial analysts. Consequently, the overall average DCF result for the proxy group is the best estimate of the ILECs' cost of equity. An adjustment for intragroup variations is improper and only serves to make the final result a less accurate cost of equity estimate.

Finally, an upward adjustment to the DCF result to encourage infrastructure development is not needed. An accurate cost of capital determination provides the correct investment incentives. An excessive return merely raises interstate access rates even further above economic costs, thereby discouraging investments by telecommunications firms purchasing that service.

The represcribed rate of return should be based on an objective application of the DCF model without making judgmental modifications to achieve a preconceived end result. We further note that the ILEC parties, although they favor no represcription at all, do not propose the types of adjustments discussed in ¶41 of the Notice.

D. Stock Price Measurement

Mr. Cummings disputes the proposal in the Notice to measure the RBOC stock prices using the average high and low for the month (pp. 25-26). He expresses concern that a daily price could be unduly distorted by a "news story" or other anomalous market activity. He therefore recommends using a ten-day average.

Mr. Cummings' concern that a "spot" price could be distorted by a market anomaly is a legitimate concern. However, his remedy of using a ten-day average is puzzling. Market anomalies (such as the recent interest rate spike) can persist for several weeks. Consequently, we recommend that the Commission measure the RBOC stock prices over a representative long

period, i.e., at least six months.[20] If a period this long is used, then dividend yields each month can be calculated using the average of the monthly high and low stock price as suggested in the Notice.

E. The Need for Risk Premium Evidence

U S WEST and Mr. Cummings advocate the use of a CAPM analysis in conjunction with the DCF to reach conclusions concerning of cost of equity. While we agree with Mr. Cummings that at least conceptually the CAPM is a valid methodology, introducing it into the rate of return represcription would serve only to add unnecessary controversy and complexity.

As discussed by Mr. Cummings (pp. 26-33), there are a number of judgments and decisions which enter into an application of the CAPM, including the selection of betas, the definition of a "risk free" asset and the expected stock market rate of return. The CAPM cost of equity results will be very sensitive to the manner in which each of these issues is resolved. For example, as of mid-1998, the RBOC Value Line betas averaged 0.90 (July 10, 1998).[21] By comparison, the Standard & Poor's betas for the RBOCs average only 0.64 (August 1998). If one assumes a risk premium of 7.0 percentage points, the data source selected for the beta would thus affect the end result cost of equity by 180 basis points. The grounds on which one would select Value Line over S&P or vice versa are unclear.

The more serious problem with the use of a CAPM methodology lies in estimating the stock market rate of return (or risk premium). Mr. Cummings suggests two methods, (1) after-

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[20] This is the same methodology the Commission used when it set the current rate of return of 11.25 percent.

[21] As of January 8, 1999, the Value Line betas for the RBOCs and GTE average 0.83.

the-fact earned returns on stocks and bonds averaged over the last 73 years; and (2) conducting a DCF analysis on the entire stock market (i.e., the S&P 500). The problem with the former method is that return expectations and risk premiums undoubtedly change over time, and for reasons not entirely understood. It would only be by pure coincidence that today's risk premium would equal the 73-year historical average.

The second method, while having the advantage of being prospective, raises the following troubling question. If the task at hand is to measure the RBOC (ILEC industry) cost of equity, why would we do so by applying the DCF model to the entire S&P 500, rather than to the industry we are targeting, i.e., the RBOCs? How does a DCF study of the S&P 500 contribute to the reliability of the cost of equity estimate? If this method is to be employed, then there are a series of analytic issues which must be addressed. For example, what should be done with the non-dividend paying stocks? If IBES survey growth rates are used, should there be a minimum number of contributing analysts for a company to be included? Should growth rates above a certain ceiling value be excluded as implausible? The stock market DCF introduces numerous complexities and difficulties not encountered in simply applying the classic DCF formula to the RBOCs.

VI. CONCLUSION

MCI WorldCom urges that the Commission represcribe the rate of return using the methodology proposed in the Notice. The cost rates for debt and preferred stock and capital structure should follow the methodology provided in Appendix B of the Notice, updated when 1998 ARMIS data become available. These data plainly show that the ILECs have financed their capital stock using 43 percent debt and 57 percent equity, a ratio which appears to conform with

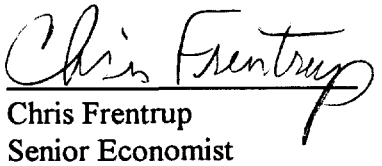
strong credit rating standards. The ILEC party claims that the capital stock is (or should be) financed either today or prospectively using only 20 percent debt is implausible and contradicted by the evidence.

The cost of equity can be readily determined by applying the classic DCF model to the RBOC group. There is no need for the various judgmental adjustments to the DCF calculated return, as discussed in ¶41 of the Notice.

Finally, contrary to the positions of the ILEC parties, any change in the represcribed rate of return should be incorporated into the LFAM for the price cap ILECs in order to retain the original purpose of that mechanism.

Respectfully submitted,

MCI WorldCom, Inc.



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March 16, 1999

STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on March 16, 1999.

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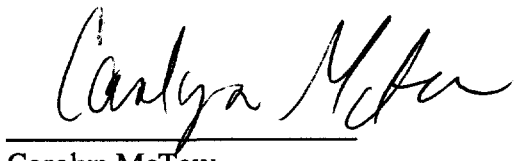
CERTIFICATE OF SERVICE

I, Carolyn McTaw, do hereby certify that on this 16th day of March 1999, I caused a copy of the foregoing Reply Comments of MCI WorldCom, Inc. to be served upon each of the parties listed on the attached Service List by U.S. First Class mail, postage prepaid.



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